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SURRENDERING SOVEREIGNTY TO SACRAMENTO: STATE-LOCAL FISCAL RELATIONS DURING THE 1990s

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Introduction and Summary

In the late 1970s, voter-approved ballot measures such as Proposition 13 and court decisions severely constrained local governments' freedom to raise revenue. By default, they thrust upon Sacramento the responsibility to offer compensatory revenue – in fiscal parlance, to "backfill" lost revenue. The backfill system worked adequately – at least, there were no serious efforts to revise it – until the recession of the 1990s. Then local governments learned that what Sacramento giveth, it could (and did) taketh away. Booming economic growth that followed the recession allowed the State to adopt compensatory efforts that restored some of the lost revenue, but the partial return of revenue came with a catch: typically the backfilled revenue was earmarked for specific purposes designated by the Legislature or the voters. Thus in the 1990s fiscal control over California local governments continued the trajectory of centralization in Sacramento that began two decades earlier. This centralization of power strained already tense state-local fiscal relations. To date all attempts to resolve the tension and reduce the fiscal inequities that have grown over time have met with little success; the challenges inherent in reforming the state-local fiscal relationship are large and – so far – insurmountable.

This article discusses trends in the state-local fiscal relationship during the 1990s. Its observations and conclusions:

- 1) Over time during the 1990s, local governments lost fiscal independence (i.e., fiscal autonomy). Loss of local government fiscal autonomy resulted from state action, voter-approved initiatives, and court rulings.
- 2) Faced with a deep recession during the early 1990s, the State not only cut back its own spending, but also converted discretionary local revenues into earmarked funds whose use was governed by lawmakers in Sacramento. Simultaneously, the State imposed additional program mandates (i.e., mandatory service provision responsibilities) on local governments. These actions were only partially reversed when the State's economic fortunes improved significantly later during the decade.

- 3) Losses in local discretionary spending exacerbated the local government fiscal stress spawned by Proposition 13, increased the competition between local governments for scarce revenue, and intensified the tendency of local governments to base land use decisions on the potential tax revenues the land may generate.
- 4) Passage of Proposition 218, together with the California Supreme Court's 1995 *Guardino* decision (discussed later in this chapter) constrained local governments' abilities to raise money independently of Sacramento.
- 5) The recessionary tidal wave of the early 1990s swamped all boats. However, the rising tide of the State's strong economic recovery in the middle and late 1990s did not lift all boats equally. Some regional economies remain weak, while others are thriving. The state-local fiscal relationship has become sufficiently complex that merely reversing the changes made during the early 1990s will not adequately address differences in local economic strength or funding needs.
- 6) Widespread recognition of local government fiscal stress has spawned several independent attempts to propose solutions. To date, none of the recommended solutions have received the widespread support necessary for adoption.
- 7) The prospects for near-term resolution of tensions in the state-local fiscal relationship are poor, although several recently-completed reform efforts - and others recently begun - offer hope that a long-term solution may be found.

Major Milestones in California State-Local Fiscal Relations

Proposition 13 (1978): A landmark initiative constitutional amendment that spawned two decades of further ballot measures, litigation, and legislation designed to respond to the shift in power and resources caused by its passage. It reduced total property taxes collected by limiting property tax rates to 1% of assessed value and limiting the growth in taxable assessed valuation; it also authorized the State to allocate property tax revenue, thereby usurping a significant amount of fiscal independence from local governments.

AB 8 (1979): The statutory authority used by the State to reallocate property taxes in accordance with Prop. 13; its complicated formulas restored a portion of the revenue lost by local governments as a result of Proposition 13 and shifted the responsibility for funding schools from local governments to the State.

Proposition 62 (1986): An initiative statute intended to require a popular vote for any new locally-imposed tax or any increase in an existing locally-imposed tax; it was embroiled in legal controversy until December 1995, when the California Supreme Court upheld its constitutionality.

Major Milestones in California State-Local Fiscal Relations (cont'd)

State-Local Realignment (1991-92): Part of the package developed by the Wilson Administration and the Legislature to help close a \$14 billion budget gap caused by the deep recession of the early 1990s. "Realignment" legislation reallocated revenues and program responsibilities between the State and local governments; the realignment shifted responsibilities for funding health and welfare programs to local governments (primarily counties) and transferred sales tax and vehicle license fee revenue to local governments to help fund the increased spending responsibilities.

Property Tax Shifts (1992-93 and thereafter): A continuation of the State's actions to help balance its budget in response to the deep recession of the 1990s. The shifts reversed a portion of the AB 8 backfill by taking back some of the revenue shifted to local governments by AB 8 and using it to fund schools, thereby reducing the amount of General Fund revenue the State had to allocate for school funding.

Proposition 172 (1993): Part of the State's and the voters' attempts to relieve local government fiscal stress caused by the property tax shifts. This initiative constitutional amendment established a 0.5-cent statewide sales and use tax to fund local public safety services; revenues are deposited into the Local Public Safety Fund and allocated to counties based on sales during the prior year and (to a much lesser extent) to cities based on amounts lost as a result of the property tax shifts; use of the revenues is limited to public safety services.

Trial Court Funding Changes (1990s): Over time during the 1990s, the State took over the responsibility for funding trial courts from the counties and allowed cities and counties to retain more of their fine and penalty revenues. Changes in trial court funding represent a significant shift in program responsibility between counties and the State and the largest return of discretionary revenue from the State to local governments during the decade.

Proposition 218 (1996): An initiative constitutional amendment that piggy-backed on Propositions 13 and 62 by significantly constraining local governments' abilities to impose new taxes and raise existing ones. This initiative requires a vote of the people to impose any new tax, increase any existing tax, and impose several types of fees and benefit assessments; a simply majority vote is required for general purpose taxes; a two-thirds majority is required for special-purpose taxes.

Vehicle License Fee Relief (1998-99 and 1999-00): Legislation enacted in 1998 and 1999 reduced vehicle license fees relative to their levels in prior years, established General Fund revenue targets (so-called "triggers") that will generate further VLF reductions in future years if they are met, and backfilled local revenue losses that would have resulted from the VLF reduction. VLF relief increased local governments' reliance on the State, because the VLF is a local revenue source, and the State's willingness to backfill VLF revenue lost as a result of the fee reductions is reversible at the State's discretion

The 1980s: The Legacy of Proposition 13

Changes in the state-local fiscal relationship are most readily chronicled – and most readily understood – if one understands the property tax allocation mechanism created by passage of Proposition 13 in 1978 and AB 8 in 1979. Proposition 13, for the uninitiated, was a landmark anti-tax measure passed decisively by California voters frustrated with property tax bills they perceived as spiraling out of control at the same time state coffers were bulging.¹ That property taxes were a local revenue source unrelated to the State's surplus was of little importance to voters. They sought tax relief, and that relief completely overhauled California's traditional method of paying for government while spawning a nationwide taxpayer revolt. Under Proposition 13, governments were required to seek voter approval before imposing certain types of taxes. Property values were rolled back to their 1975-76 levels for tax assessment purposes and allowed to rise no more than 2% per year in the years following. Property tax rates were capped at 1% of assessed value. Property was reassessed only when sold or substantially modified. Authority to allocate property tax revenue was taken from local governments and placed with the State. In the first year alone, property tax collections decreased by over \$6 billion.²

In the years since its passage, Proposition 13 has been the subject of extremely detailed analysis and review. Its effects, while still being studied, are far-reaching and complex, and far too numerous to summarize in the limited space available here. In this chapter, therefore, we limit our discussion to two effects of particular importance to the state-local fiscal relationship:

- 1) Proposition 13 spawned a shift in the state-local fiscal relationship. Prior to passage of the initiative, local governments were free to raise much of their discretionary revenue using the property tax. Some local governments chose to do so, others did not, but the option was available to all. There was no cap on the maximum property tax rate in any jurisdiction, nor were there any significant constraints on property valuation. When the State passed AB 8 (Greene, Chapter 282, Statutes of 1979) as a means of relieving local governments' Proposition 13-imposed fiscal stress, it established the framework for local governments' current fiscal constraints. In passing AB 8³, the State took over the responsibility for allocating property tax revenue and agreed to take on a significant level of responsibility for funding public schools. To do so, the State shifted property tax revenues from schools to other local entities (cities, counties, special districts, and redevelopment agencies) and

¹ Proposition 13 passed with 64.8 percent of the vote and received majorities in 55 of the State's 58 counties (all but San Francisco, Kern, and Yolo). (Doerr, David, "Capsule History of the California Tax Structure, Part V, 1965-1979, The Struggle for Property Tax Reform and Relief, Chapter Four, 1977-1979: The Passage of Proposition 13." Available at <http://www.caltax.org/taxhist.htm>. The State's 1977-78 surplus, the largest ever in California's history in percentage terms, was \$3.9 billion, approximately one-third of the State's entire General Fund (California Budget Project, "State and Local Government Finance in California: A Primer," July 1996, Page 30.).

² California Budget Project, "Proposition 13: Its Impact on California and Implications for State and Local Finances," April 1997.

³ Proposition 13 authorized the State to allocate property taxes according to law (a responsibility that had previously rested with local governments). AB 8 provided the statutory formulas for the allocation.

replaced the property tax revenues with revenue from the State's General Fund. This shift, together with the State's assumption of many county health and welfare costs, reduced the local entities' revenue losses but made the local governments significantly more dependent on the State's willingness to continue the backfill.⁴ By the early 1990s, this dependence had become so great that the State's decision to reverse some of the Proposition 13 backfill created significant shortfalls at the local level, particularly for counties.

- 2) It created significant uncertainty regarding the vote requirements needed to approve locally-imposed taxes. Prior to Proposition 13, most local governments were free to impose and increase taxes without seeking voter approval. In an attempt to rein in local governments' taxing power, Proposition 13 imposed a two-thirds vote requirement on any local government seeking to impose a special-purpose tax. Unfortunately, the proposition's ambiguous wording and lack of definitions created nearly two decades of confusion and litigation regarding vote requirements necessary to approve local taxes. The issue (raised but unresolved by Proposition 13) was whether local governments needed a vote of the people to impose or increase taxes, and what vote requirements were needed for general- versus special-purpose taxes.

Compared to the significant impact of Proposition 13 on the state-local fiscal relationship, relatively little changed on the local government fiscal landscape during the 1980s. The AB 8 allocation mechanism proceeded on with few significant changes and the ambiguity over vote requirements for tax imposition remained unresolved. Although Proposition 62 of 1986 was intended to alleviate the confusion over vote requirements for locally-imposed taxes, the debate continued unresolved until December 1995.⁵ The State agreed to take on a greater role in funding trial courts through its adoption of the Trial Court Funding Program in 1985, but by 1990, the State was still funding only 38% of trial court operations.⁶ The trial court funding measures of the 1980s (see further discussion below in the "Trial Court Funding" section) were not, in and of themselves, of great significance to local governments during the 1980s; of greater significance was the framework they established for significant changes in trial court funding during the 1990s.

The 1990s: Deep Recession Followed by Booming Economic Growth

Key changes in state-local fiscal relations occurred during the 1990s. Most were generated by the State's need to balance its budget in response to the severe recession early in

⁴ Legislative Analyst's Office, "Major Milestones: 25 Years of the State-Local Fiscal Relationship" in *California Update*, December 1997, p. 2 and "Shifting Gears: Rethinking Property Tax Shift Relief," February 2, 1999, p. 2. Most of the Legislative Analyst's Office publications cited in this paper are accessible on the LAO web site, <http://www.lao.ca.gov>.

⁵ See the discussion below regarding Proposition 62 and the *Guardino* decision.

⁶ Legislative Analyst's Office, "Trial Court Funding 'Realignment'", *1992-93 Perspectives and Issues*, February 1992, pp. 137-152. The State has traditionally funded the State Supreme Court and the appellate courts but relied on counties to provide the vast majority of funding for the trial courts.

that decade.⁷ Some reflected voters' wishes for input into local governments' decisions to impose or increase taxes, fees, and assessments. Nearly all resulted in a loss of local government fiscal autonomy. The major topics to be discussed below include:

- "State-local realignment" and the Local Revenue Fund
- The property tax shifts
- The Local Public Safety Fund and Proposition 172
- Trial court funding
- Proposition 62, the *Guardino* decision, and Proposition 218
- Vehicle license fee reduction

1991-92: State-Local Realignment and the Local Revenue Fund

In 1991, as part of the package developed by the Wilson Administration and the Legislature to help close the budget gap, the State implemented a significant shift in responsibilities for funding health and welfare programs, a shift that has come to be known as "state-local realignment." The framework for the realignment was contained in three separate measures (AB 758, Bates, Chapter 87, Statutes of 1991; AB 948, Bronzan, Chapter 91, Statutes of 1991; and AB 1288, Bronzan, Chapter 89, Statutes of 1991). While the specifics of the shift are extremely complex, they accomplished the following general changes:⁸

- 1) The State transferred full responsibility for funding mental health care, public health programs, and indigent care to the counties, thereby reversing many of its earlier post-Proposition 13 actions to assume counties' health and welfare costs;
- 2) The State shifted the responsibility for funding many other health and social services programs to the counties by increasing the percentage of non-federal contributions for which counties were responsible. This committed much discretionary revenue that would otherwise have been available for non-health and welfare programs;
- 3) The State enacted an additional 0.5% sales and use tax rate and increased vehicle license fees. Both sources of revenue were deposited into the Local Revenue Fund and dedicated to local

⁷ Within days after taking office, Governor Pete Wilson was faced with a \$14.5 billion budget shortfall. The Governor and the Legislature closed this gap and the smaller (but still substantial) ones that followed in the next four fiscal years using six strategies: 1) raising fees and taxes, 2) cutting spending (through a combination of overall reductions in expenditure programs and shifts in program responsibilities from the State to local governments), 3) shifting property tax revenues away from cities, counties, special districts, and redevelopment agencies to schools, 4) shifting state and local costs to the federal government, 5) accelerating revenues into earlier fiscal years and deferring costs into future fiscal years, and 6) borrowing externally. Nearly all of these changes impacted the state-local fiscal relationship.

⁸ Legislative Analyst's Office, "Major Milestones: 25 Years of the State-Local Fiscal Relationship", op cit., p. 2, "The County-State Partnership", *1991-92 Perspectives and Issues*, February 1991, pp. 179-186, and "Local Government Overview," *Cal-Guide: A Profile of State Programs and Finances*, January 1995, pp. 2-3 of the downloadable, web-based version.

governments for health and welfare costs shifted to them as part of the programmatic realignment.

The State intended program realignment to relieve the State of many health and welfare responsibilities while being revenue-neutral for local governments. However, revenue neutrality was not achieved. The State's funding backfill fell short of fully reimbursing local governments for their increased costs in the initial year of realignment. This shortfall increased in subsequent years; the demand for (and therefore the cost of) services provided by the counties grew faster than the combined revenue stream used by the State to help backfill county costs.⁹ It is likely that the disparity in growth rates between local government costs and backfill revenues shrank after the recession when California's economy strengthened. However, a precise accounting of these differences is not available.

Together, the actions that comprised the 1991-92 state-local realignment had three major outcomes:

- 1) They reversed one of the significant elements of the AB 8 backfill by requiring counties and other local governments to reassume responsibility for providing health and welfare services that the State had agreed to assume immediately after passage of Proposition 13;
- 2) They saddled local governments (counties almost exclusively) with a significant increase in service provision responsibilities without providing sufficient funding to carry out those responsibilities. Local governments were left to cut service levels and use previously discretionary revenues to backfill their shortfalls. The disparity in growth rates between program costs and backfill revenues increased the amount of discretionary revenue that counties were forced to redirect to fund health and welfare costs over time;
- 3) They provided local governments (counties, in particular) with targeted, rather than discretionary revenue from the State. Both the sales and use tax and vehicle license fee revenue transferred to the Local Revenue Fund were restricted; counties had only limited flexibility in how they could spend their Local Revenue Fund allocations.

In the years following the 1991-92 realignment, the State implemented two significant changes in the health and welfare area with impacts on the state-local fiscal relationship. The first, effective January 1, 1997, provided counties with increased flexibility in fulfilling their responsibilities as providers of last resort.¹⁰ This action was intended to give counties the ability to reduce their costs of providing assistance to indigents who lack other means of support.¹¹ The

⁹ Legislative Analyst's Office, *Cal-Guide*, *ibid*.

¹⁰ SB 681 (Hurt), Chapter 6, Statutes of 1996.

¹¹ General Assistance (GA), which is required to be provided by counties pursuant to Part 5 of the Welfare and Institutions Code, is California's welfare program of last resort. Typically, individuals who receive GA are individuals, usually single men, who are not eligible for assistance under the Temporary Assistance for Needy Families or Supplemental Security Income/State Supplementary Programs. A thorough discussion of GA is

second major action, which was part of the welfare reform effort initiated by the State in 1997, provided fiscal incentives to counties that moved aid recipients off welfare and/or reduced welfare fraud.¹² Neither of these two changes has been in effect long enough at this writing for the long-term fiscal impact to be known.

1992-93 and 1993-94: Property Tax Shifts

In 1992 and 1993, the State continued to reverse the backfill enacted in AB 8 by redirecting approximately \$4 billion (one-sixth) of all property tax revenues from cities, counties, special districts, and redevelopment agencies to schools. In order to accomplish the redirection, state law was changed to require every county auditor to deposit a portion of city, county, and special district property taxes into a countywide Educational Revenue Augmentation Fund (ERAF). The "property tax shifts" lessened the amount that the State had to pay to support schools but removed a significant amount of discretionary revenue from many local governments. Although complicated, the formulas used to calculate the shifts were intended to reflect the amounts each entity had received under the original AB 8 allocation formula. The amount of the shift varies by entity but has grown each year in direct proportion to the growth of each community's assessed valuation. With few exceptions, the property tax shifts have remained in place since their inception.¹³

The shifts had four primary effects:

- 1) They removed a significant amount of discretionary revenue from local government coffers, causing service cutbacks. Although a specific tally of the impacts is unavailable, anecdotal reports suggest that general assistance, library, and parks and recreation programs were the programs most significantly affected;
- 2) They exacerbated the "fiscalization" of land use, i.e., the tendency of communities to base land use decisions on the net tax revenues the land will generate for the community.¹⁴ By significantly reducing the amount of property tax revenues received by cities, counties, and special districts, the property tax shift reduced local governments' reliance on that revenue source. It rendered these local governments more reliant on other sources of revenue (most notably the sales tax, locally-imposed fees and assessments, and on state funding);

included in the Legislative Analyst's Office *1996-97 Perspectives and Issues* in the chapter titled, "Counties and the 1996-97 State Budget."

¹² Legislative Analyst's Office, *Analysis of the 1998-99 Budget Bill*, February 1998, Department of Social Services CalWORKs Program (5180), pp. C-112-C-113.

¹³ Legislative Analyst's Office, "Reversing the Property Tax Shifts", April 2, 1996, 11 pages and "Property Tax Shift," *1997-98 Perspectives and Issues*, February 1997, pp. 203-213.

¹⁴ Kotin, Allan, and Richard Peiser, "Public-Private Joint Ventures for High Volume Retailers: Who Benefits?", *Urban Studies*, Vol. 34, No. 12, 1997, p. 1975 as cited in Lewis, Paul and Elisa Barbour, "California Cities and the Local Sales Tax." Public Policy Institute of California, 1999, p. 68.

- 3) They reduced counties' incentives to manage the property tax collection system in a manner that maximizes revenue collection. Because counties now receive about 20% of all property tax revenue but pay over 70% of the property tax administration costs,¹⁵ they have relatively little incentive to administer property tax collection aggressively;
- 4) They significantly exacerbated the tension between local governments and the State and increased the confrontational relationship and profound distrust of both sides toward each other.

Ever since the property tax shifts began, there has been talk of ending them. Some have suggested a freeze, others a reduction, still others a complete halt, and still others a halt combined with a refund for past revenue losses. To date, however, the shifts have remained in place, although, as noted in subsequent sections of this chapter, the State has made some attempts to alleviate local government fiscal stress resulting from them.

1993: Local Public Safety Fund and Proposition 172

In 1993, in an effort to help backfill some of the property tax revenues shifted from local governments, the Legislature enacted a temporary 0.5-cent sales and use tax to help fund local public safety services (SB 509, Committee on Budget and Fiscal Review, Chapter 73, Statutes of 1993). Tax revenues were placed in the Local Public Safety Fund. The legislatively-approved tax was scheduled to remain in effect from July 1, 1993 through December 31, 1993, but was made permanent when the voters passed Proposition 172 in November 1993. The 0.5-cent tax is administered by the State but distributed primarily to counties (and to a much lesser extent to cities). Revenues, which currently total about \$2 billion annually, are allocated to counties based on sales during the prior year and to cities based on amounts lost as a result of the property tax shifts. In accordance with the wishes of the Legislature (and later the voters), Local Public Safety Fund revenue may be used to fund sheriffs, police, fire protection, county district attorneys, and county corrections. Fund money may not be used to support the courts.¹⁶

The significance of the Local Public Safety Fund is as follows:

- 1) It substituted a state-controlled, narrowly-targeted source of revenue for previously discretionary revenue that was lost by local governments as a result of the property tax shifts;
- 2) It contributed to local governments' reliance on sales tax revenues, thereby increasing the incentives toward fiscalization of land use.

¹⁵ Legislative Analyst's Office, "Property Tax Shift," *1997-98 Perspectives and Issues*, op cit., p. 204.

¹⁶ Government Code Section 30051.

1991 through 1998: Trial Court Funding

Trial court funding has played a key role in the state-local fiscal relationship throughout the 1990s. During the 1991 realignment, the State increased its funding of locally-run trial courts while at the same time increasing state revenues from court fines. No fewer than eight measures addressing trial court funding were enacted during 1991, but the one that made the most sweeping changes was AB 1297, Isenberg, Chapter 90, Statutes of 1991. Together, the measures intended to help close the state budget gap, relieve county fiscal pressures by shifting trial court funding costs from the counties to the State, and enact court reforms intended to improve access to justice and improve the efficiency of court operations.¹⁷ The fiscal elements of trial court funding reform:

- 1) Increased the State's contribution for trial court funding. The measures were intended to fund 50% of trial court costs in 1991-92 and to increase the State contribution by 5% annually until the State assumed 70%. Unfortunately for counties, the severe recession prevented the State from meeting these targets, and the State's contributions, although higher than they had been during the 1980s, were still far below 70% by the time of the next trial court funding reform (see below);
- 2) Shifted fine and penalty revenues previously available to cities and counties to the State to help backfill the costs of increased state support for the trial courts and help close the State's large budget gap;
- 3) Enacted changes in fine and penalty collection procedures intended to improve collections, thereby generating more money for the State to use as backfill.

At the time the trial court reform measures were passed, the State expected fine and penalty revenues to offset the costs of increased court funding until at least 1995-96, when the State's costs of trial court support would exceed the shifted fine and penalty revenues.¹⁸ Although the precise revenue impact of the 1991 trial court funding changes on the State and local governments is not known, the following is clear:

- 1) The shift in fine and penalty revenues did not produce the revenue increases the State had hoped for;
- 2) Counties remained responsible for a significant level of trial court funding support. The State backfill may have alleviated some of the counties' fiscal stress, but all local governments continued to be short of discretionary funds and long on mandatory service provision responsibilities.

¹⁷ Legislative Analyst's Office, "Trial Court Funding Realignment," op cit., pp. 139-142.

¹⁸ Ibid., p. 143.

Trial court funding played an even greater role during the late 1990s upon passage of the Lockyer-Isenberg Trial Court Funding Act of 1997 (AB 233, Escutia and Pringle, Chapter 850, Statutes of 1997). This measure changed many of the funding allocations put into place by the 1991 act. It arguably represented the most significant move by the State to help address local government fiscal stress and reverse nearly a decade of reductions in local governments' fiscal autonomy. Under the Lockyer-Isenberg Act¹⁹:

- 1) The State assumed all trial court costs for the 20 least-populated counties;
- 2) The State capped amounts that had to be contributed by the other 38 counties and assumed responsibility for funding all future growth in trial court costs;
- 3) The State capped the amount of fine and penalty revenues that counties had to send to the State and allowed counties to keep all future fine and penalty revenue growth above the cap levels;
- 4) The State allowed cities to retain all of their fine and penalty revenues, money that had previously gone to the State's General Fund.

Further changes in 1998 (AB 2788, Thomson, Chapter 1017, Statutes of 1998) increased the State's buyout of counties' trial court costs by decreasing the amounts that need to be contributed by the 38 counties whose share of costs has not been completely bought out. The 1999-00 state budget also provided limited one-time money to counties for other court costs (such as salary increases for trial court employees, increased court staffing, and funding for technology projects, drug programs, and court security).²⁰

The significance of the 1997 and 1998 trial court funding changes is twofold:

- 1) They represent a significant assumption of previously local costs by the State (annual local government relief is in the range of \$700 million to \$800 million annually);²¹ the fiscal relief afforded to certain small counties is substantial;
- 2) They represent the largest return of *discretionary* revenue to local governments since local governments' fiscal autonomy began to erode in the early 1990s.

1995: Proposition 62 and the *Guardino* Decision

As the foregoing discussion indicates, many of the significant changes in the state-local fiscal relationship during the 1990s resulted from state action. However, ignoring the importance

¹⁹ Legislative Analyst's Office, "Judiciary and Criminal Justice, Trial Court Funding (0450), *Analysis of the 1998-99 Budget Bill*, February 1998, pp. D-115-D-116.

²⁰ Legislative Analyst's Office, "Judiciary and Criminal Justice, Trial Court Funding (0450), *Analysis of the 1998-99 Budget Bill*, February 1999, pp. D-117-D-118.

²¹ *Ibid.*, D-117.

of California voters in altering the state-local fiscal relationship during the 1990s would provide an incomplete picture. Just as the State constrained local government spending and replaced several previously discretionary revenue streams with dedicated revenues, the California voters, with help from the California Supreme Court, constrained local governments' abilities to raise revenue.

The first voter-approved initiative with an impact in the 1990s was placed before the voters in 1986. Proposition 62, a statutory initiative approved by the voters in November 1986, intended to require a vote of the people for any new locally-imposed tax or any increase in an existing locally-imposed tax. Under the initiative:²²

- 1) A majority vote of the electorate was required for local general-purpose taxes;
- 2) A two-thirds vote of the electorate was required for local special-purpose taxes;
- 3) Taxes enacted after July 31, 1985 and in existence as of the date of the initiative's passage had to be put to a vote by the local governments imposing them within two years after the initiative's passage. Taxes that were not placed before the voters by November 1988 or that failed to receive approval from the appropriate percentage of voters by November 1988 had to be repealed.

The initiative became embroiled in lengthy legal controversy shortly after its passage, and its intention to clarify the vote requirement issue was not fulfilled for many years. In 1988, an appellate court ruled that Proposition 62's voter approval requirement for existing taxes was unconstitutional on the grounds that the statute represented an unconstitutional referendum on taxation. In 1991, another appellate court used the same reasoning to find that Proposition 62's requirement for popular votes on new local taxes was unconstitutional. Reasoning that appellate courts had found multiple provisions of proposition unconstitutional, many local governments ignored the initiative and continued to impose taxes without seeking voter approval during the mid- to late-1980s and through the early 1990s.

The controversy over the proposition was not resolved until 1995, when the proposition's third major provision (its clarification that a two-thirds vote was required for new special-purpose taxes) was decided by the California Supreme Court. The 1995 decision stemmed from the actions of the Santa Clara County Local Transportation Authority, which sought voter approval of a 0.5-cent sales tax in 1992. The tax, which was intended to replace a countywide transportation sales tax set to expire in 1995, was approved by 54.1 percent of the voters. When Santa Clara County sought to issue bonds backed by the anticipated revenues, the County's auditor/controller (Carl Guardino) refused pending a court's determination regarding the validity of the tax. At issue was whether a tax levied by a special-purpose authority represented a general- or a special-purpose tax. The case was finally settled in December 1995 when the

²² Text of Proposition 62, California Voter's Pamphlet for the November 1986 General Election, California Secretary of State, p. 41 and California Taxpayers' Association, "Local Taxes Require Voter Approval: Supreme Court Revives Proposition 62," *Cal-Tax Policy Brief*, April 1996, pp. 1-4.

California Supreme Court *Guardino* decision became final (*Santa Clara County Local Transportation Authority v. Guardino*, 11 Cal. 4th 220).²³ In ruling that the tax was a special- rather than a general-purpose levy (and thus invalid because it failed to receive a two-thirds majority), the Court made three significant findings:

- 1) Taxes imposed by special-purpose authorities require a two-thirds vote for approval. This has a great deal of significance for transportation authorities seeking to impose new sales taxes or renew sales taxes set to expire;
- 2) Proposition 62 is constitutional. Because the court wished to clear up the legal uncertainty surrounding the proposition, it did not base its ruling on constitutional grounds or legal precedent (as had the appellate courts), but rather on the statutes enacted by Proposition 62. In finding Proposition 62 constitutional, the Supreme Court overturned prior appellate court rulings challenging its application. Thus, the court decision clarified that a vote of the people is required before any new locally-imposed tax may be enacted;
- 3) General-purpose taxes require a simple majority for passage and/or increase. Special-purpose taxes require a two-thirds majority for passage and/or increase.

Somewhat surprisingly, the Supreme Court's declaration that Proposition 62 was constitutional did not end the controversy over voter-approval of local taxes. Because Proposition 62 was an initiative statute rather than an initiative constitutional amendment, its application to charter cities was uncertain. Also uncertain was the status of taxes approved in the time period between the initiative's passage and its finding of constitutionality. Although legislation was proposed to address the latter issue (see for example, SB 1590, O'Connell from the 1995-96 Legislative Session), no bill addressing the issue reached the Governor's desk. Furthermore, although the Howard Jarvis Taxpayer's Association (HJTA) threatened to challenge several taxes imposed and/or increased in the period between November 1986 and December 1995 in hopes that the courts would resolve Proposition 62's remaining outstanding issues,²⁴ none of these cases progressed very far before HJTA qualified an initiative for the 1996 ballot that ultimately became Proposition 218.

1996: Proposition 218

Proposition 218, an initiative constitutional amendment approved by the voters in November 1996, had several aims:²⁵

²³ Ibid.

²⁴ Tax Analysts, *State Tax Notes*, February 26, 1996, p. 616. The HJTA's namesake was one of the architects of Proposition 13.

²⁵ Coupal, Jonathan, "Proposition 218: The Drafters' Statement of Intent," *Cal-Tax Digest*, February 1997, pp. 7-14.

- 1) Clearly define -- once and for all -- what is meant by a "general-purpose" and a "special-purpose" tax and clarify the vote requirements necessary to impose each type of tax;
- 2) Ensure that all taxes and most charges on property owners are subject to voter approval;
- 3) Prevent any special purpose district or agency from levying a general tax;
- 4) Ensure that taxes are used to raise general-purpose revenue, while fees and assessments are used to fund special benefits;
- 5) Ensure that fees and assessments are imposed in proportion to usage of the benefits by each person required to pay.

Like Proposition 13 and Proposition 62, Proposition 218 made several changes that significantly limited local governments' abilities to raise revenues. Proposition 218 placed the following requirements in California's Constitution²⁶:

- 1) Any local government that began imposing a general-purpose tax during 1995 or 1996 without a vote of the people was required to place that tax before the voters prior to November 1998 and receive the proper majority for approval. Failure to place such a tax before the voters or to receive the necessary majority (simple majority for general taxes, two-thirds majority for special taxes) prevented a local government from continuing to impose the tax after November 1998. Taxes approved prior to 1995 were exempt from this provision;
- 2) Beginning in November 1996, any local government wishing to impose a new tax or increase an existing tax must seek voter approval. A simply majority is required to approve new or increased general-purpose taxes, and a two-thirds majority is required to approve new or increased special-purpose taxes. Proposition 218 clarified that any tax imposed for a specific purpose is a special tax, even if its funds are placed into the community's General Fund;
- 3) Any local government imposing an assessment at the time Proposition 218 was passed was required to evaluate whether voter approval was required for the assessment's continued imposition. Voter approval was not required if: a) the assessment was approved by a majority of voters or affected property owners at the time of its creation, or b) all of the assessment proceeds were pledged to bond repayment, or c) all of the assessment proceeds were used to pay for sidewalks, streets, sewers, water, flood control, drainage systems, or vector control (e.g., mosquito abatement). If the assessment did not meet any of the criteria for exemption from voter approval, the local government imposing it had a choice of discontinuing the assessment or seeking voter approval by July 1997;
- 4) Beginning in November 1996, any local government wishing to impose a new assessment or increase an existing assessment must seek the approval of those who will be required to pay

²⁶ Text of Proposition 218, California Voter's Pamphlet for the November 1996 General Election, California Secretary of State.

the assessment. Proposition 218's voter requirements for imposing assessments are intended to prevent any assessment from being used to generate general-purpose revenue; the initiative was intended to limit assessments to the provision of "special" benefits. Proposition 218's voter approval requirements are also intended to ensure that any property owner receiving a special benefit pays no more or less than his or her proportional share of the total cost relative to the entire group of property owners receiving the same benefit. This intention is achieved by weighting votes in proportion to each property owner's assessment liability;

- 5) Beginning in November 1996, any local government wishing to impose a new fee for any service *other than* water, sewer, or refuse collection must place that fee to a vote. The local government may choose to allow a vote by the entire electorate in the affected area (in which case a two-thirds majority is required for approval) or may limit those voting on the fee to those who will be required to pay the fee (in which case a simple majority is required for approval and the local government may weight votes in proportion to fee liability). Proposition 218's rules for fees are similar to those for assessments and are intended to prevent the use of fees to fund general government services and target the imposition of fees to those who actually receive services funded by the fees. In practice, the fees that will have to be put to a vote under Proposition 218 are those that benefit communities as a whole rather than specific properties (e.g., police and fire protection, ambulance service, recreational facilities, libraries, etc.).

While obviously complicated, Proposition 218 did succeed in clarifying many aspects of local governments' fiscal autonomy. Furthermore, although the proposition has not been in effect long enough for its long-term impacts on local governments to be discerned at this writing, initial evidence suggests that the initiative has:

- 1) Led to increased fiscalization of land use;
- 2) Led to the increasing use of bond financing to fund local projects;
- 3) Encouraged heavier reliance on development fees and exactions for increased local funding;²⁷
- 4) Pushed local governments to be more creative in their revenue-raising. One example of such creativity was provided by Santa Clara County, which placed two companion measures on its November 1996 ballot. Measure A (which passed with a 77.6% majority) was an advisory measure stating the voters' wishes that the County use any new sales tax funds for a list of transportation improvements listed in the voter pamphlet; Measure B (which passed with a 51.8% majority) was a 0.5% sales tax whose proceeds would be placed in the county's General Fund. In 1998, a California appellate court ruled that the Measure B tax was a general tax and therefore valid because it had been approved by over 50% of those voting on the issue (*Robert F. Coleman et al. v. County of Santa Clara*, 1998 Cal. App. 509). Other

²⁷ Dresch, Marla and Steven Sheffrin, "Who Pays for Development Fees and Exactions," Public Policy Institute of California, pp. 9-10.

local governments are expected to use similar companion measures when seeking to extend or increase local sales taxes in the future.

1998-99 and 1999-00: Vehicle License Fee Relief

In 1998, the State adopted a tax relief package that included a 25% reduction in the vehicle license fee (VLF) beginning on January 1, 1999, with the potential that VLF relief could grow further in subsequent years depending on whether state revenues exceeded so-called "trigger" levels.²⁸ The State enacted a further 10% VLF reduction in 1999.²⁹ The State's decision to reduce vehicle license fees holds significance for local governments, because the VLF represents a substantial source of local government revenue. Pursuant to the State Constitution, all VLF revenue is dedicated to local governments.³⁰

The amount of VLF raised annually is sizeable. In 1998-99, VLF collections were projected to be approximately \$3.9 billion. Seventy-five percent of this revenue is distributed to cities and counties on a per capita basis for discretionary purposes and twenty-five percent is distributed to almost exclusively to counties to fund health and welfare programs pursuant to the 1991-92 state-local realignment.³¹

Significantly, and in a move that harkens back to post-Proposition 13 passage of AB 8, the statutes enacting the VLF reduction also backfill local governments' revenue losses from the reduction. Thus, to date, local governments have continued to receive what they would have received if the VLF had not been reduced; the difference between VLF collections and transfers to local government is made up by the state General Fund.³² However, just as the State was able to partially reverse the AB 8 backfill when a deep recession hit during the early 1990s, the State also retains the ability to reduce or eliminate the VLF backfill. For that reason, the VLF reduction, just like the AB 8 backfill, significantly increased local governments' dependence on the State.

Looking To The Future

In February 1999, the Legislative Analyst's Office (LAO) published a brief ("Shifting Gears: Rethinking Property Tax Shift Relief") in which it found that the property tax shift redirects approximately \$3.6 billion annually from local governments to the State. Mitigation measures enacted by the State (e.g., Local Revenue and Local Public Safety Funds, trial court funding, and other, smaller mitigation measures) return about \$2.2 billion annually to local governments. However, the LAO also found that the mitigation measures have not benefited all

²⁸ AB 2797 (Machado), Chapter 322, Statutes of 1998.

²⁹ AB 1121 (Nakano), Chapter 74, Statutes of 1999. The additional reduction, which reduced VLF 35% relative to its level in 1998, applies for the 2000 calendar year only. It extends into 2001 and future years only if certain state revenue targets are met.

³⁰ Article XI, Section 15.

³¹ Legislative Analyst's Office, "A Primer on the Vehicle License Fee," June 17, 1998, 8pp.

³² The amount of the transfer is sizeable -- approximately \$1.5 billion in the 2000 calendar year.

local governments equally (nor has the shift harmed all local governments equally). According to the LAO, 13 of the State's 58 counties (about 20%) and 20% of the State's nearly 500 cities are better off now than they were prior to the property tax shift. The remainder have lost revenue. Thus it is clear that a mere end to the property tax shift does not provide an easy solution to the challenges faced by local governments. What is needed is a comprehensive solution that increases local government fiscal autonomy while simultaneously addressing and effectively responding to the different policy challenges facing local governments throughout the State.

At first glance, the future would appear to be brightening for local governments. The 1999-00 state budget subvented \$150 million in one-time General Fund relief to local governments (\$75 million to cities and counties on a per capita basis and \$75 million to cities, counties, and special districts in proportion to their property tax shift losses); provided \$425 million to an infrastructure bank that provides below-market rate loans to local jurisdictions for infrastructure projects; increased the amount of state relief available for trial court funding by nearly \$100 million; and augmented local government funding for law enforcement, detention facilities, mental health, and public libraries.

Yet, the prospects for more comprehensive reform are less than bright, at least in the short-term. The 1999-00 budget proposed to cap the property tax shifts and buy out of a significant portion of counties' property tax administration costs.³³ But these actions are contingent on passage of a constitutional amendment reforming the state-local fiscal relationship, an amendment whose content is as yet unknown at this writing. Other efforts currently underway at the State level would drop the voter approval requirements from two-thirds to a simple majority for passage of education-related bonds, with the intention of allowing local governments to more easily obtain voter approval for bond issuance. But, the Legislature has deadlocked on the issue, and the two-thirds Legislative approval needed to place such a proposal on the state ballot has been elusive.

Notwithstanding the challenges, several groups have offered suggestions aimed at improving the state-local fiscal relationship in the long-term. This chapter will not provide a complete review of the reform efforts but will recognize some of the more significant ones. Certainly, the LAO has played a crucial role in advising the Legislature and the public about the challenges facing the State and providing clear, cogent explanations of the changes in state-local fiscal relations as they have changed over time. "Making Government Make Sense" remains one of the most thoughtful contributions to the policy debate aimed at improving the efficiency with which the State and local governments combine to raise revenue and provide services.³⁴

The California Constitution Revision Commission, created in 1993 with the aim of developing recommendations to improve the State's budget process, reform the state-local fiscal relationship, and strengthen local governments' fiscal health, developed several recommendations

³³ This provision is contained in a budget trailer bill (AB 1661, Torlakson, Chapter 84, Statutes of 1999).

³⁴ Legislative Analyst's Office, "Making Government Make Sense," February 1993, 15 pages.

for reform.³⁵ Since 1994, the California Governance Consensus Project has worked to forge agreement among public and private interests on reforms that would restore accountability and fiscal stability to local government and ensure that revenue streams provide incentives for balanced growth and reform the state-local fiscal relationship.³⁶ Legislation enacted in 1997 created the Commission on Local Governance for the 21st Century, which is investigating the relationship between local fiscal stability and land use decisions (along with several other local land use issues).³⁷ Furthermore, in 1998, the Speaker of the State Assembly convened the Blue-Ribbon Commission on State-Local Fiscal and Tax Policy with the aim of developing a comprehensive solution to the state-local fiscal relationship that will restore fairness and balance to the relationship and begin to reestablish mutual respect between the long-warring parties.³⁸

Time will tell whether one of the commissions or task forces currently at work is successful at devising a long-term compromise acceptable to all of the parties with a stake in state-local fiscal relations. When such a solution is considered in the context of the constraints imposed by Propositions 13, 62, and 218; the property tax shifts and the mitigation measures enacted by the State in response to the shifts; the existence of over 5,300 local governments (including cities, counties, and special districts); an extremely diverse population of over 33 million people; and a long history of animosity and distrust between the State and local governments, long-term success may well be elusive.

³⁵ California Constitution Revision Commission, "Final Report and Recommendations to the Governor and the Legislature," June 1996. Information about the Commission and its recommendations is available at <http://www.library.ca.gov/ccrc>

³⁶ Information on the Consensus Project is available at <http://www.csus.edu/calst/cgcp>

³⁷ The Commission was created by AB 1484, Hertzberg, Chapter 943, Statutes of 1997 and modified by AB 2621, Hertzberg, Chapter 1038, Statutes of 1998. More information on the Commission is available at <http://www.clg21.ca.gov>

³⁸ Villaraigosa, Antonio, Welcoming Remarks to the Civic Entrepreneurs Summit in San Diego, Ca., September 15, 1998, reprinted in "Speaker Villaraigosa Announces New Blue-Ribbon Commission on State-Local Fiscal and Tax Policy," *Metro Investment Report*, September 1998, Volume VI, No. 4. More information on the Blue-Ribbon Commission is available at <http://speaker.metroforum.org>